

DIGITAL GOODS - AN OVERVIEW OF TAX TREATMENT AROUND THE COUNTRY

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CLASSIFICATION

DIGITAL GOODS

- SST definition of “specified digital products” means electronically transferred:
 - “**Digital Audio-Visual Works**” which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any.
 - “**Digital Audio Works**” which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones.

DIGITAL GOODS

- SST definition of “specified digital products” means electronically transferred:
 - “**Digital Books**” which means works that are generally recognized in the ordinary and usual sense as “books.”
 - For purposes of the definitions of specified digital products, “transferred electronically” means obtained by the purchaser by means other than tangible storage media.

CLOUD COMPUTING

- “Cloud computing is a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.” (National Institute of Standards and Technology)

SOFTWARE AS A SERVICE (“SAAS”)

- The *SaaS* model allows the consumer to use the provider’s software applications running on a cloud infrastructure.
- The applications are accessible from various client devices through a client interface such as a web browser (e.g., web-based email).
- The consumer does not manage or control the underlying cloud infrastructure including network, servers, operating systems, storage, or application capabilities.

SOFTWARE AS A SERVICE (“SAAS”)

- Under the SaaS model a service agreement is almost always executed (vs. a software license agreement or services agreement for an ASP).
- Use of a license agreement could change the characterization from a service to a software license
- SaaS model is familiar to most Internet users, and includes such offerings as web-based e-mail, calendars, word processing, and digital photo applications.

COMPUTER SOFTWARE

- Tangibly Delivered: Software that is delivered on a tangible medium, such as a disk or CD.
- Electronically Delivered: Software is transferred by electronic means (downloaded from the internet) as opposed to delivered in a tangible format

CHARACTERIZATION

- What are you buying?
 - Tangible personal property
 - Software
 - Service
 - Something else
- How is it delivered?
 - Tangible form
 - Electronically delivered
 - Electronically accessed
 - Electronically streamed

CHARACTERIZATION (CONT.)

- Emerging trend to tax digital goods and various bills have been proposed to tax digital services.
 - “‘Tangible personal property’ means personal property that can be seen, weighed, measured, felt, or touched, or that is *in any other manner perceptible to the senses*. ‘Tangible personal property’ includes electricity, water, gas, steam, and prewritten computer software.” SSUTA, Appendix C.

TAXABILITY

CHARACTERIZATION – SAAS

- States have taken varying approaches. For example:
 - **New York** – Taxable as sales of tangible personal property (prewritten computer software).
 - **Texas** – Taxable as data processing services (20% of service exempt from tax).
 - **South Carolina** – SaaS taxable as telecommunications services. (Note: based on the August 2014 ruling in Private Letter Ruling #14-2, there may be a position to exempt SaaS. However, other rulings that are more specific continue to tax SaaS.)

CHARACTERIZATION – SOFTWARE AS A SERVICE (CONT.)

- States have taken varying approaches. For example:
 - **SST States**.....varies:
 - **Utah** – Taxable as the sales of tangible personal property (prewritten computer software) if any software resides on computer even temporarily (applets/cookies).
 - **Wisconsin** – Exempt data processing services.

SPECIFIED DIGITAL PRODUCTS AND DIGITAL CODES ARE SUBJECT TO ARKANSAS SALES TAX

- Effective January 1, 2018, Arkansas sales and use tax applies to specified digital products sold to a purchaser who is an end user with the right of permanent use or less than permanent use granted by the seller regardless of whether the use is conditioned on continued payment by the purchaser.
- If none of the standard sourcing rules apply as the seller does not have information regarding the customer's location, the sale will be sourced to the location from which the specified digital product or digital code was first available for transmission by the seller.
- (Act 141 (H.B. 1162), Laws 2017, effective January 1, 2018)

SALES OF ONLINE BANKING PRODUCTS SUBJECT TO TAX IN UTAH

- The sale of licenses to financial institutions for the use of online banking and bill payment, a finance and budget tool, and mobile banking products in SaaS transactions was subject to Utah sales tax when the financial institution customers were located in Utah.
- The essence of the transaction was the sale of the use of the company's prewritten computer software.
- (*Private Letter Ruling, Opinion No. 15-005*, Utah State Tax Commission, November 16, 2015, released January 2016)

DIGITAL GOODS VS. THE CLOUD

- Digital goods may be downloaded to the subscriber's device
- An applet may be required for installation
- Cloud services rarely require or allow a full download of an application.
- Digital goods may be transferred with a perpetual use license where Cloud services are typically time based and not perpetual.
- Michigan considers digital goods exempt
- Pennsylvania taxes digital goods regardless of method of delivery or access and considered TPP

TAX TREATMENT FOR SAAS LICENSED VS. SAAS SERVICES

- The tax treatment for SaaS Licensed and SaaS Services can differ in some states:
 - In the following states, a SaaS license agreement is taxable, while a SaaS service agreement is exempt:
 - Alabama
 - Kentucky
 - Mississippi
 - New Jersey

TAXABILITY OF DIGITAL GOODS - WASHINGTON

- The retailing B&O tax rate of 0.471% and the wholesaling B&O tax rate of 0.484% apply to retail and wholesale sales of digital goods, digital codes, digital automated services, remotely accessed prewritten software, and repair or installation of digital goods (RCW 82.04.257(1))

TAXABILITY OF DIGITAL GOODS - TEXAS

- Sales of internet-delivered digital products are taxable as sales of tangible personal property
- However, digital magazines and digital newspapers are considered “data processing” and 20% of the base is exempt

TAXABILITY OF DIGITAL GOODS – NEW YORK

- Sales of digital products transferred electronically (i.e., downloaded music, ringtones, movies, books, etc.) are not subject to New York sales and use tax (TSB-A-08(63)S and 08(8)C ; TSB-A-07(16)S ; TSB-A-07(14)S)

TAXABILITY OF DIGITAL GOODS – OHIO

- Specified digital products provided for permanent or less than permanent use are taxable, regardless of whether continued payment is required.
- "Specified digital product" means an electronically transferred digital audiovisual work, digital audio work, or digital book.
- Sec. 5739.01(B)(12), Ohio R.C.
- Digital magazines & newspapers used for business purposes are taxable

TAXABILITY OF DIGITAL GOODS – ARIZONA

- Sales of digital property delivered electronically are generally subject to tax.
- AZ Reg. R15-5-154

CHICAGO PERSONAL PROPERTY LEASE TRANSACTION TAX

- Cloud applications are taxed if users are in Chicago
- Applications which allow customer to input, modify or retrieve their own data or information is reduced rate of 5.25%
- Other applications including licensed software and information services taxed at 9%
- New Small Business Exemption
 - Less than 60 months in operations
 - Less than \$25M annual sales

BUNDLING

- Be aware that if both taxable and non-taxable components are bundled on an invoice or contract (i.e. not separately stated), then the non-taxable items may be subject to tax
- Some states look to true object or have de minimus tests

SOURCING

SOURCING FOR THE CLOUD

- Sourcing is dependent upon characterization. For interstate sales, if taxable as:
 - Tangible Personal Property
 - Generally destination
 - Consider subsequent use
 - Consider concurrent use
 - Location of hardware when IaaS or PaaS
 - Services vary by state. May be:
 - Benefit
 - Performance
 - Billing address
 - Consider multi-state benefit

SOURCING FOR THE CLOUD (CONT.)

- Sourcing is dependent upon characterization. For interstate sales, if taxable as:
 - Digital goods are not clearly defined. May be:
 - Destination
 - Benefit
 - Billing Address
 - Consider multi-state benefit

SOURCING FOR THE CLOUD (CONT.)

- What are the problems?
 - Concepts of destination and benefit are not easily applied to digital items.
 - The seller may have no idea where the receipt of the items takes place, or where the item is used.
 - From a purchaser perspective, location of use may not always be known – or may be at multiple locations.

SOURCING FOR THE CLOUD (CONT.)

- Electronically delivered or accessed software:
 - Challenges arise when the agreement permits multiple users to make a copy of the software and install it on multiple devices
 - Is “Use” at the server location or at the user location?
 - Trend towards user location but this is problematic for the seller to know if user locations are not required under the contract
 - Be careful of states that include software or digital products in their definition of tangible personal property

SOURCING FOR THE CLOUD (CONT.)

- Remote storage (backup):
 - Is “Use” at location where the data is stored as a backup?
 - Is “Use” at the location where the equipment is located on which the original data exists?
 - Is “Use” at the location of the user who will retrieve the data?
 - Indiana – online backup software not taxable as true object was the storage service

SOURCING FOR THE CLOUD (CONT.)

- Allocation or Apportionment
 - SST Multiple Points of Use MPU. Provision was eliminated a number of years ago.
 - Although this concept was eliminated from the SST agreement, many states not only permit allocation or apportionment of the tax base, but require it
 - State statutes and regulations often do not provide an answer/approach. Rather, a “range” of acceptable answers is the norm. Consider Washington state:
 - The taxable amount is determined by the number of users in this state compared to users everywhere.
 - New York only taxes portion of users in state but no method or exemption form provided

SOURCING FOR THE CLOUD (CONT.)

- In allocating or apportioning the tax base:
 - Develop a Sensible and Uniform Approach
 - Uniform does not mean that all transactions are equal
 - A particular purchase should be allocated in the same manner to each state
 - How does one source between multiple states?
 - Based on expected usage?
 - Based on actual usage?
 - Based on a pro-rata split?
 - Based on “value” of the usage
 - Others?

SOURCING FOR THE CLOUD (CONT.)

- Allocation or Apportionment
 - Most auditors will look for a sensible approach that assigns sales to locations where the service is being “received.”
 - State Authority Silent? Consider:
 - Complete Auto Transit, Inc.
 - Goldberg v. Sweet
 - Central Greyhound Lines, Inc. v. Mealy et al
 - Oklahoma Tax Commission v. Jefferson Lines

ADMINISTRATION

INVOICING AND CONTRACT BEST PRACTICES

- If you only deliver software electronically, make sure that the invoice/contract doesn't say otherwise
- Use the terminology for software licensing only when that's what you're doing.
- Don't use a software license if you are providing SaaS or a service
- For SaaS, don't mention licenses or delivery
- For allocation (where users are located), will you contractually require the customer to specify where the users will be or will you be silent on it?

QUESTIONS/COMMENTS

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